



DEPARTMENT OF  
**FINANCE**

ARNOLD SCHWARZENEGGER, GOVERNOR

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October 10, 2006

Ms. Selvi Stanislaus, Executive Officer  
Franchise Tax Board  
P.O. Box 1468, Mail Stop A390  
Sacramento, CA 95812

Dear Ms. Stanislaus:

**Final Report—Quality Assurance Review**

Enclosed is our final quality assurance review report on the Franchise Tax Board's Internal Audit Bureau (Bureau). The report provides an opinion on the Bureau's compliance with the Institute of Internal Auditors' *International Standards for the Professional Practice of Internal Auditing*, and suggestions for quality improvement. The final report includes the Bureau's response to the recommendations.

In accordance with the Department of Finance's (Finance) policy of increased transparency, this report will be placed on the Finance website. We appreciate your staff's cooperation and assistance during our review. If you have any questions regarding this report, please contact Susan M. Botkin, Manager, or Brandon Nunes, Supervisor, at (916) 322-2985.

Sincerely,

*Original Signed By:*

Diana L. Ducay, Chief  
Office of State Audits and Evaluations

Enclosure

cc: Mr. Geoffrey Way, Division Chief, Administrative Services Division, Franchise Tax Board  
Mr. Philip Yu, Director of Internal Audits, Internal Audit Bureau, Franchise Tax Board

# A QUALITY ASSURANCE REVIEW

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## Franchise Tax Board Internal Audit Bureau

Prepared By:  
Office of State Audits and Evaluations  
Department of Finance

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The three-member Franchise Tax Board (Board) consists of the State Controller, the Chairman of the State Board of Equalization, and the Director of Finance. The Executive Officer, appointed by the Board, implements the policies and performs such duties as are delegated by the Board. The mission of the Board is to efficiently and effectively administer tax and other programs entrusted to the Board, and to collect revenues needed to serve the people of California. The Board administers the Personal Income and Corporation Tax Laws through the Tax Program which includes self-assessment, audit, collection and filing enforcement activities. These activities contribute to a significant portion of the state's annual General Fund revenue.

The Board's Internal Audit Bureau (Bureau) is an independent appraisal activity established to conduct reviews of operations and procedures, to provide counsel, and to make recommendations for improvement to the Board's management. The vision of the Bureau is to become the premier internal audit office that operates with maximum efficiency, fosters continuous quality improvement, and provides exemplary protection for the Board while recognizing the changing dynamics of management and technology.

The Department of Finance, Office of State Audits and Evaluations, conducted this quality assurance review in accordance with the Government Code Section 13071, which requires the State's internal auditors to comply with the Institute of Internal Auditors' *International Standards for the Professional Practice of Internal Auditing*. These standards require that the Board's Bureau receive an external quality assurance review at least once every five years.

This report is intended solely for the information and use of the Board's management and is not intended to be and should not be used by anyone other than this specified party. However, this report is a matter of public record and its distribution is not limited.

**STAFF:**

Susan M. Botkin, CGFM  
Manager

Brandon Nunes  
Supervisor

Kwabena Boayke, CPA

### Review Objectives

Our primary objectives were to: (1) determine the Internal Audit Bureau's (Bureau) compliance with the Institute of Internal Auditors' *International Standards for the Professional Practice of Internal Auditing (Standards)*, (2) appraise the quality of the Bureau's operations, and (3) provide recommendations for improving the Bureau's compliance with the *Standards*.

The *Standards* encompass the following:

- The Institute of Internal Auditors' *International Standards for the Professional Practice of Internal Auditing*

Attribute Standards:

- 1000—Purpose, Authority, and Responsibility
- 1100—Independence and Objectivity
- 1200—Proficiency and Due Professional Care
- 1300—Quality Assurance and Improvement Program

Performance Standards:

- 2000—Managing the Internal Audit Activity
- 2100—Nature of Work
- 2200—Engagement Planning
- 2300—Performing the Engagement
- 2400—Communicating Results
- 2500—Monitoring Progress
- 2600—Resolution of Management's Acceptance of Risks

- The Institute of Internal Auditors' *Code of Ethics*

### Review Scope

In order to assess the Bureau's compliance with the *Standards*, we reviewed its activities for the period January 1, 1999 to April 30, 2006. We conducted our review in accordance with the Institute of Internal Auditors' *Quality Assessment Manual, Fourth Edition*. The scope of our review included:

- A self-study report, completed by the Director of Internal Audits, which provided background information concerning the Bureau's organizational status, operating environment, practices, policies, and procedures.
- Interviews with the Executive Officer, Chief of Administrative Services Division, Director of Internal Audit Bureau, and Internal Audit Manager.

- An audit survey sent to selected audit customers, which solicited their responses concerning the scope, nature, and quality of internal auditing.
- A review of audit policies, procedures, practices, and information used for managing the Bureau.
- Reviews of selected audit reports and working papers.

We conducted our fieldwork during June 2006.

## Opinion

In forming an overall opinion on the Bureau's compliance with the *Standards*, we utilized the opinions delineated in the *Quality Assurance Review Manual, Fourth Edition*, as defined below.

**Generally Conforms**—Policies, procedures, and an internal auditing charter existed and were deemed to be in accordance with the *Standards*. Any deficiencies found in applying the policies, procedures, and charter provisions were deemed minor.

**Partially Conforms**—Policies, procedures, and an internal auditing charter existed, but they were not in complete compliance with the *Standards*, or significant deficiencies in practice were found that deviated from the *Standards*.

**Does Not Conform**—Existing policies, procedures, and an internal auditing charter, where present, were deemed not to comply with the *Standards*, and/or deficiencies in practice were so significant as to seriously impair audit quality.



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## O PINION

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We completed an independent quality assurance review of the Franchise Tax Board's Internal Audit Bureau (Bureau), based on an evaluation of the Bureau's practices and audits completed during the period January 1, 1999 to April 30, 2006. In our opinion, the Bureau *generally conforms* with the Institute of Internal Auditors' *International Standards for the Professional Practice of Internal Auditing (Standards)*.

This opinion means that policies, procedures, and an internal auditing charter existed and were deemed to be in accordance with the *Standards*. Any deficiencies found in applying the policies, procedures, and charter provisions were deemed minor. Our opinion is based on fieldwork conducted during June 2006.

Specific instances of minor deficiencies with the *Standards* are described in the *Conditions and Recommendations* section of this report. Our recommendations, if implemented, will assist the Bureau in improving audit quality and ensuring continued compliance with the *Standards*.

### *Original Signed By:*

Diana L. Ducay, Chief  
Office of State Audits and Evaluations  
(916) 322-2985

June 21, 2006

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## CONDITIONS AND RECOMMENDATIONS

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This section contains our observations on the Internal Audit Bureau's (Bureau) compliance with the *International Standards for the Professional Practice of Internal Auditing (Standards)*. For each category, we cite the *Standards* and discuss the Bureau's compliance. For those areas containing minor deficiencies, we recommend corrective action for fully implementing the applicable standard.

**A. 1000—Purpose, Authority, and Responsibility (Charter): The purpose, authority, and responsibility of the internal audit activity should be formally defined in a charter, consistent with the *Standards*, and approved by the board of directors/audit committee.**

A written audit charter is critical to managing the internal audit function because it defines the unit's purpose, authority, and responsibility. Specifically, the audit charter establishes the role of the internal audit activity within the Franchise Tax Board (Board) and provides a basis for management's evaluation of the operations. The following deficiencies were identified:

**Condition:** The Bureau's audit charter had not been updated as of the end of our audit period, April 30, 2006, to reflect the current reporting structure of the Bureau. In June 2006, the Bureau updated the audit charter to reflect the new reporting structure.

Further, the internal audit manual, which contains the policies and procedures guiding the internal audit function, makes references to the old *Standards* instead of the new *Standards* that became mandatory for all Institute of Internal Auditors members effective January 1, 2004.

**Criteria:** *Standard* 1000, Practice Advisory 3 states that the Chief Audit Executive (CAE) should periodically assess whether the purpose, authority and responsibility, as defined in the charter, continue to be adequate to enable the internal audit activity to accomplish its objectives.

*Standard* 2040 states that the CAE should establish policies and procedures to guide the internal audit activity.

**Recommendation:** Update the audit manual to reflect the new *Standards*.

**B. 1100—Independence and Objectivity: The internal audit activity should be independent, and internal auditors should be objective in performing their work.**

The Bureau's independence is achieved through its reporting structure and organizational status. The Bureau reports administratively and functionally to the Administrative Services Division Chief and the Board's Executive Officer, respectively.



**C. 1200—Proficiency and Due Professional Care: Engagements should be performed with proficiency and due professional care.**

Bureau management appropriately supervises the staff to assure conformance with the *Standards*. Generally, Bureau management and staff collectively possess the knowledge and skills essential for the professional practice of internal auditing. However, the following deficiency was identified:

**Condition:** Two internal audit staff did not meet the education requirement specified in the State Personnel Board (SPB) job specification for the Management Auditor position series.

**Criteria:** *Standard* 1210 states that the internal auditors should possess the knowledge, skills and other competencies needed to perform their individual responsibilities.

**Recommendation:** Fill vacant internal audit positions with staff that meet SPB job specifications.

**D. 1300—Quality Assurance and Improvement Program: The CAE should develop and maintain a quality assurance and improvement program that covers all aspects of the internal audit activity and continuously monitors its effectiveness.**

The Bureau does not have a formal quality assurance committee. However, supervisors provide timely reviews of all working papers and audit reports. Review notes are prepared by the supervisor to give constructive feedback to the auditor for continuous improvement. The Bureau also utilizes a checklist to enable auditors unfamiliar with the audit to independently review the workpapers for quality assurance. In addition, the Bureau utilizes staff training and evaluations to enhance the quality and effectiveness of its activities. Although not part of a formal review program, these procedures, when combined with the audit staff's experience, ensure compliance with the *Standards*.

**E. 2000—Managing the Internal Audit Activity: The CAE should effectively manage the internal audit activity to ensure it adds value to the organization.**

The Bureau is generally managed efficiently and effectively. Annual audit plans are generally prepared in accordance with the *Standards*. However, we identified the following deficiency:

**Condition:** The Bureau did not conduct a formal risk analysis of the Board and did not develop the annual or long-range audit plans based on the analysis of risk. *This is a recurring condition from a prior Quality Assurance Review.*

Further, accomplishment reports that outline the Bureau's audit activities are not submitted to the Executive Officer.

**Criteria:** *Standard* 2010 states that the CAE should establish risk-based plans to determine the priorities of the internal activity, consistent with the organization's goals.

*Standard* 2010A.1 states that the internal audit activity's plan of engagements should be based on a risk assessment, undertaken at least annually.

*Standard 2060* states that the CAE should report periodically to the board and senior management on the internal audit activity's purpose, authority, responsibility and performance related to its plan. Reporting should also include significant risk exposures and control issues.

**Recommendation:** Perform a formal risk assessment of the organization and base the plans of engagement on the assessed risk. Also, prepare and submit accomplishment reports to the Executive Officer.

**F. 2100—Nature of Work: The internal audit activity should evaluate and contribute to the improvement of risk management, control, and governance processes using a systematic and disciplined approach.**

The nature of the Bureau's work conforms with the *Standards*. The scope of work includes the examination and evaluation of the Board's internal control, compliance reviews, and other special projects requested by Board management.

**G. 2200—Engagement Planning: Internal auditor should develop and record a plan for each engagement, including the scope, objectives, timing and resource allocations.**

The Bureau's audit work is performed in accordance with the *Standards*. The working papers contain evidence of planning through audit planning memorandums.

**H. 2300—Performing the Engagement: Internal auditors should identify, analyze, evaluate, and record sufficient information to achieve the engagement's objectives.**

The Bureau's audit work is generally performed in accordance with the *Standards*. The working papers contain sufficient, competent, and relevant evidence and information to support the conclusions and reports.

**I. 2400—Communicating Results: Internal auditors should communicate the engagement results.**

The Bureau's audit work is generally performed in accordance with the *Standards*. Audit reports are accurate, objective, constructive, and complete.

**J. 2500—Monitoring Progress: The CAE should establish and maintain a system to monitor the disposition of results communicated to management.**

The Bureau's audit work generally conforms with the *Standards*. Auditees are required to provide timely status reports on findings and recommendations. The Bureau also performs follow-up reviews on the auditees after one year.

**K. 2600—Resolution of Management's Acceptance of Risks: When the CAE believes that senior management has accepted a level of residual risk that may be unacceptable to the organization, the CAE should discuss the matter with senior management. If the decision regarding residual risk is not resolved, the CAE and senior management should report the matter to the board of directors/audit committee for resolution.**

The Bureau's audit work is performed in accordance with the *Standards*. The Director of the Internal Audit Bureau discusses significant matters with the Executive Officer.

- L. The *Code of Ethics*:** The Code of Ethics are principles relevant to the profession and practice of internal auditing, and rules of conduct that describe behavior expected of internal auditors. The Code of Ethics applies to both parties and entities that provide internal audit services. The purpose of the Code of Ethics is to promote an ethical culture in the global profession of internal auditing.

The Bureau management and staff reflect, through their work, that they uphold and follow the *Code of Ethics*.

## CONCLUSION

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This report discusses the Internal Audit Bureau's (Bureau) responsibility to operate under the Institute of Internal Auditors' *International Standards for the Professional Practice of Internal Auditing (Standards)*, the objective of our quality assurance review, and an overview of the Bureau's compliance with the *Standards*. The Bureau is aware of the requirement to operate in compliance with the *Standards*.

We met with the Executive Officer, Division Chief of Administrative Services, and the Director of the Bureau on June 21, 2006 to discuss our observations reported in the *Conditions and Recommendations* section of this report.





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## MEMORANDUM

To: Diana L. Ducay, Chief  
Office of State Audits and Evaluation  
Department of Finance

September 28, 2006

From: Selvi Stanislaus

Subject: Responses to Quality Assurance Review

Thank you for the opportunity to review the draft audit report. We appreciate your recommendations for improving our Internal Audit functions. Our responses to the Quality Assurance Review are as follows:

### **1000 – Purpose, Authority, and Responsibility (Charter):**

**The purpose, authority, and responsibility of the internal audit activity should be formally defined in a charter consistent with the Standards, and approved by the board of directors/audit committee.**

**Condition:** The Internal Audit Manual, which contains the policies and procedures guiding the internal audit function, makes references to the old Standards instead of the new Standards that became mandatory for all Institute of Internal Auditors members effective January 1, 2004.

**Recommendation:** Update the audit manual to reflect the new Standards.

**FTB Response:** We are in the process of updating the Internal Audit Manual to reflect the Standards. We are expecting to complete the updates by the end of this fiscal year.

### **1200 – Proficiency and Due Professional Care:**

**Engagements should be performed with proficiency and due professional care.**

**Condition:** Two internal audit staff did not meet the education requirement specified in the State Personnel Board (SPB) job specification for the Management Audit position series.

**Recommendation:** Fill vacant internal audit positions with staff that meet SPB job specifications.

**FTB Response:** One of two staff that did not meet the education requirement of the job specification has left the unit. In the future, we will make sure our Management Auditor recruitments meet the education requirement of the job specification.

**2000 – Managing the Internal Audit Activity:**

**The CAE should effectively manage the internal audit activity to ensure it adds value to the organization.**

**Condition:** The Bureau did not conduct a formal risk analysis of the Board and did not develop the annual or long-range audit plans based on the analysis of risk. This is a recurring condition from a prior Quality Assurance Review.

Further, accomplishment reports that outline the Bureau's audit activities are not submitted to the Executive Officer.

**Recommendation:** Perform a formal risk assessment of the organization and base the plans of engagement on the assessed risk. Also, prepare and submit accomplishment reports to the Executive Officer.

**FTB Response:** The Internal Audit Bureau will conduct a formal risk analysis of the department to develop our annual and five-year audit plan beginning next fiscal year. In addition, rather than requiring a monthly report, I will meet with the Internal Audit Bureau Director on a quarterly basis to keep abreast of the Bureau's activities.

If you have any questions regarding the responses, please contact Philip Yu, Director of Internal Audit at (916) 845-3388.

*Original signed by:*

Executive Officer

cc: Geoff Way, Chief, Administrative Services Division  
Philip Yu, Director, Internal Audit Bureau